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MSA.N - Q1 2023 MSA Safety Inc Earnings Call

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PRESENTATION

Operator

Good day, and welcome to the MSA First Quarter 2023 Earnings Conference Call. (Operator Instructions) Please note, this event is being recorded.

I would now like to turn the conference over to Chris Hepler. Please go ahead.

Chris Hepler - *MSA Safety Incorporated - Executive Director of Corporate Development & Investor Relations*

Thank you. Good morning, and welcome to MSA Safety's First Quarter 2023 Earnings Conference Call. This is Chris Hepler, Executive Director of Corporate Development and Investor Relations. With me today are Nish Vartanian, Chairman, President and CEO; Lee McChesney, Senior Vice President and CFO; and Steve Blanco, Segment President for the Americas.

Before we begin, I'd like to remind everyone that matters discussed during this call may include forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, but are not limited to, all projections and anticipated levels of future performance.

Forward-looking statements involve a number of risks, uncertainties and other factors that may cause our actual results to differ materially from those discussed today. These risks, uncertainties and other factors are detailed in our SEC filings. MSA Safety undertakes no duty to publicly update any forward-looking statements made on this call, except as required by law.

We have included certain non-GAAP financial measures as part of our discussion this morning. The non-GAAP reconciliations are available in the appendix of today's presentation. The presentation and press release are available on our Investor Relations website at investors.msasafety.com.

Moving on to today's agenda. First, Nish will discuss key highlights of the quarter. He will then turn the call over to Lee to discuss our financial performance and outlook. Nish will then conclude with closing remarks. Following our prepared remarks, we will open the call for questions.

With that, I'll turn the call over to Nish.

Nishan J. Vartanian - *MSA Safety Incorporated - Chairman, President & CEO*

Thanks, Chris. Good morning, everyone. We appreciate you joining us today. I'm on Slide 4. I want to start with a brief story that has a very important reminder. MSA's purpose runs deep in our company, and our employees are very often involved in community work that ties closely to our mission.

One of our associates locally here in Pittsburgh, who also serves as a volunteer firefighter responded to a house fire recently, where tragically, 2 children were killed by the smoke and flames. The investigation identified that there were no smoke detectors in the home, which could have helped save the lives of these children.

As a result, he's become passionate about smoke detectors and launched a community event on smoke detector awareness. To amplify this important message, I want to remind everyone on this call to check your smoke and carbon monoxide detectors regularly. Change the batteries and ensure they're installed throughout your home. It can help save you or your loved one's life.

Now moving on to Slide 5. MSA had an outstanding start to the year with strong revenue, earnings and cash flow growth. We're very encouraged as this marks the third straight quarter of double-digit revenue growth and healthy incremental margins and cash flow.

Our profitable growth was a result of broad base demand for MSA's leading safety solutions. Orders were up double digits over the last year. Our book-to-bill ratio was favorable at more than 1.1x and we grew backlog sequentially.

Revenue is up a strong 20% in the quarter. We saw balanced growth across our key product categories and regions. Growth in our shorter cycle products like Portable Gas Detection, Head Protection and Fall Protection was strong in the quarter. Our Fixed Gas Detection business also saw solid growth and orders. And in Firefighter Safety, we saw healthy growth in Breathing Apparatus and Protective Apparel, specifically in our Globe business.

So to all of our MSA associates around the globe, thank you for delivering another great quarter. Results like these are driven by your unwavering dedication to our mission of safety.

We also take great pride in our ability to design innovative solutions that address our customers' toughest safety challenges and improve their productivity. By putting the customer at the center of everything we do, our teams are able to design better solutions that address these challenges. This has helped us introduce better solutions to the safety industry and has resulted in leading product vitality, which was 37% for 2022. This demonstrates a strong product market fit for our solutions, and we're competing well in our markets.

A great example of this is the continued expansion of our Fall Protection portfolio, an effort that was started pre-pandemic. We recently launched the V-Shock series of self-retracting lanyards that complement our V-TEC lineup. The V-Shock product line is designed for durability, ease-of-use and improves our competitive position in the growing fall protection sector, while extending our addressable market.

And on the commercial side, we continue to see momentum in the Fire Services market with recent wins with Los Angeles City for the G1 Breathing Apparatus and Bedfordshire, United Kingdom for the M1. These contracts build on our wins that we had last year with Los Angeles County and London Fire Brigade. And we've also had recent notable wins in Chile, China and in France.

Moving on to Slide 6. As The Safety Company, our commitment to sustainability begins with our mission and is the basis for our key sustainability pillars: our products, our people and our planet. In our recently published annual report, we announced a 1.5-degree Celsius carbon reduction target, reducing our Scope 1 and 2 emissions by 42% by 2030. To achieve this target, we're incorporating sustainability principles into our daily operations across the globe. Our associates are inspired by our ambition, and we have numerous initiatives in process to help us reach our target.

Not only is sustainability incorporated in how we operate, it's also incorporated into the products we develop. As an example, we recently launched the Bacharach MGS-401 Entrance Monitor that provides improved safety to monitor areas, such as mechanical rooms and walk-in freezers, by providing accurate gas concentrations and audible and visual alarms when gas levels are too high. Importantly, the monitor also helps customers more easily comply with refrigeration safety standards. It's another way our team is bringing innovative solutions to solve our customers' evolving safety and sustainability challenges.

With that, I'll pass the call to Lee to discuss our first quarter financial results and outlook. Lee?

Lee B. McChesney - MSA Safety Incorporated - Senior VP & CFO

Thanks, Nish, and good morning, everyone. Before getting into the numbers, I want to remind you that the accounting related to the legacy liability divestiture we completed in January is in this quarter's GAAP results. In our adjusted numbers, we have removed the impact of the transaction.

Now let's get started on Slide 7 with the quarterly financial highlights. We're off to a strong start for the year with solid results across our product categories and regions. Sales were \$398 million, an increase of 20% compared to the prior year. Currency translation had a 2% unfavorable impact on sales.

Growth was well balanced between volume and price with each contributing about half. We saw improved sales in gas detection and fall protection as a result of strong demand and better supply chain conditions.

As Nish mentioned, order growth was healthy in the quarter, up double digits compared to the prior year. Book-to-bill was more than 1.1x, and backlog grew mid-teens sequentially and is up 20% from last year.

Gross margin in the quarter was 45.5%, up 230 basis points year-over-year from sound price / cost management, volume leverage and productivity. We are encouraged with the sustained progress we are seeing in gross margin. With supply chain moderation in certain product lines and the application of our Business System to our operations, we're seeing better throughput in our facilities, and that's showing in the results.

In the first quarter, adjusted operating margin was 19.4%, up 310 basis points compared to last year. Incremental margin was 35%. Adjusted net income was \$53.7 million, which resulted in diluted earnings per share of \$1.36, an increase of 24% over last year.

Now I'd like to review our segment performance. In our Americas segment, we had strong results with sales of \$280 million, an increase of 24% over the prior year. Americas saw double-digit growth across all key categories including Firefighter Safety, Gas Detection and Industrial PPE, and the growth was balanced across both North America and Latin America. Adjusted operating margin in the quarter was 25.6%, up 240 basis points year-over-year as a result of volume leverage and disciplined cost management.

In our International segment, we also had strong results. Sales were \$118 million, an increase of 12% on a reported basis and 18% on a constant currency basis. Currency translation was a 6% headwind in the quarter. From a product perspective, both Gas Detection and Industrial PPE saw double-digit growth, which was partially offset by slower growth in Firefighter Safety gear. We performed well in both EMEA and APAC. Our adjusted operating margin was 13.4% in the quarter, expanding 480 basis points over the prior year, driven by volume leverage and disciplined cost management.

Now moving to cash flow and leverage on Slide 8. Free cash flow, when adjusted for the divestiture was \$52 million or 97% of adjusted net income. Cash flow improved in the quarter from higher earnings and improved working capital and demonstrates our proven ability to deliver robust cash generation.

Our financial position is strong. In the quarter, we invested \$8 million in CapEx and returned \$18 million in dividends to our shareholders. We repaid \$18 million of debt after adjusting for the divestiture, and net debt on March 31 was \$731 million.

For the trailing 12 months ended March 31, 2023, adjusted EBITDA was \$361 million. Net leverage at quarter end was 2.0, compared to 2.2x pro forma at year-end 2022, when adjusted for the divestiture. When we announced the divestiture in January, we said we would focus on reducing leverage, and we're making measurable progress.

Now let's turn to our updated outlook on Slide 9. We have several reasons to be responsibly optimistic entering the second quarter. Demand has been resilient, and our markets continue to be well funded. Short-cycle product demand has been strong this year, and we continue to carry an elevated backlog across the business. The recent moderation in supply chain constraints and improved factory throughput give us confidence that the worst of our supply chain challenges are behind us.

We will continue to balance these positives with macro uncertainty in the back half of the year. The economy continues to be very dynamic and there's growing recession concerns across most of our key regions. Our teams are focused on those variables that are in our control and executing our strategy to deliver profitable growth, and strong cash flow like we've done for the past several quarters.

Considering these dynamics and the strong start to our year, we now expect growth for the full year in the high single-digit to low double-digit range, with incremental margins in our target range of 30% to 40% and free cash flow conversion of approximately 100%.

Before closing, I want to take a moment to thank our associates around the world for bringing our vision to life each and every day and for their strong execution this quarter. At MSA, I have now seen over and over our team's commitment to our mission of worker safety, and that approach is fueling our resilient results.

With that, I'll pass the call back to Nish for his closing remarks.

Nishan J. Vartanian - *MSA Safety Incorporated - Chairman, President & CEO*

Thanks, Lee. I'm on Slide 10. In closing, I'm encouraged by the strong start to the year. Our unparalleled portfolio of innovative safety solutions continues to gain momentum in the market. We're strategically investing in our business to accelerate key initiatives to deliver sustainable, profitable growth, and our teams are energized by our progress and driven by our mission of safety.

As we look forward, MSA's diversification across products, geographies and end markets has made our business more resilient, and our expectation is that the successful execution of our strategy will continue to drive long-term value creation.

With that, I'll turn the call back over to the operator for the Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And the first question will be from Stanley Elliott from Stifel.

Stanley Stoker Elliott - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP & Analyst*

Congratulations on the strong start to the year. Question for you guys around the fire department. I mean going to FDIC last week, there's considerable momentum that you're seeing there. You mentioned all the conversions. How do you all think about that business from a physical capacity standpoint, really just the ability to deliver, I mean even within the ones that you mentioned, you still had the Air Force and some other things out there in the works. Just curious how to think about how that business can evolve?

Nishan J. Vartanian - *MSA Safety Incorporated - Chairman, President & CEO*

Sure. Sure, Stanley. So when we built that line for the G1 SCBA, we built with plenty of flex in capacity, knowing that the business is very clumpy. As you know, typically, the AFG funding cycles in the back half of the year, and we have to ramp up production to get those units out the door predominantly in the fourth quarter. So we have plenty of capacity. We can run that line at very high rates and handle increased capacity or increased demand with ease.

I don't lose sleep over our capacity constraints; I lose sleep over to supply chains. That's really the gating issue when it comes to getting Breathing Apparatus out the door. But as far as our capacity is concerned, we're in really good shape.

Stanley Stoker Elliott - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP & Analyst*

And looking at kind of how the core products performed in the quarter, I mean, Gas Detection up 47% or so. How much of that is -- how you kind of thought about going to market differently with kind of longer-term revenue contracts, how much of that is just product uptake? Just curious kind of what you're seeing there and maybe anything you could share about some of those new go-to-market strategies.

Nishan J. Vartanian - *MSA Safety Incorporated - Chairman, President & CEO*

So what you saw in the quarter was really the result of 2 key things, Stanley. Number one, product uptake. The demand for product was really strong in the quarter. We had great demand actually starting fourth quarter and into the first quarter. We saw really good demand for Portable Gas Detection, and supply chains also were favorable. So we were able to get a lot of product out the door shipping a tremendous amount of 4 XRs, which were very successful.

On the io4 and the Connected Worker, that pipeline continues to ramp up. The business ramps up in a very favorable manner. But really, what you saw in the quarter was more about demand in the quarter, and also supply chain is getting better.

Stanley Stoker Elliott - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP & Analyst*

And then last for me, you mentioned strength in a lot of your short-cycle businesses. And then Lee, I think at the end, you mentioned kind of preparing for concerns around a recession. But it would seem like the short-cycle business would have been softer here even with the recent PMIs. Do you think it's more of kind of -- we've talked -- we've heard about infrastructure spending, megaprojects, reshoring, things along those lines, different CapEx cycles maybe potentially. But the results that you're putting up seemed to really kind of counter your concerns over what I might think about from a recessionary standpoint?

Nishan J. Vartanian - *MSA Safety Incorporated - Chairman, President & CEO*

Why don't I take that first Stanley and then pass it on to Lee for some more color. We certainly saw strength in the short-cycle products, what we call the PPE industrial space, and that was really driven by the utility market, the nonresidential construction, oil and gas and general industry. All those markets were solid for us.

We continue to monitor the pace of business closely. And as you know, we don't have tremendous line of sight in that business as you get into the second half of the year. But for now, that business looks pretty good.

And Lee, if you want to add some more color to that?

Lee B. McChesney - *MSA Safety Incorporated - Senior VP & CFO*

Yes. So I think, Stanley, what I would say there is if you go back to February when we gave an outlook, we said we're going to be cautious on that view. And if it turned out to be positive, it would be an opportunity. That's certainly what played out in the first quarter.

To Nish's point, we can only see so far there, that's the business we carry the smallest backlog in because we turn it quickly. We're expecting some of that to continue in the second quarter. That's part of the update.

And in the back half, we're just going to be balanced. But I think underneath what Nish said is, frankly, the employment levels in this area are strong. And frankly, it could even be stronger if we had more people to work in some of these trades. So we'll see how it plays out. For now, we're going to be, as I said, responsibly optimistic and maybe that will turn out to be an opportunity.

Stanley Stoker Elliott - *Stifel, Nicolaus & Company, Incorporated, Research Division - VP & Analyst*

Great guys. That's it for me.

Operator

(Operator Instructions) The next question is from Rob Mason from Baird.

Robert W. Mason - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

And good work on the quarter as well. The -- your outlook that you did raise to be high single-digit to low double-digit sales for the year, how does price factor into that growth for the full year to the extent that was roughly, I guess, about 11 points in the first quarter. How does price trend through the year?

Nishan J. Vartanian - *MSA Safety Incorporated - Chairman, President & CEO*

Thanks, Rob. Lee, why don't you take that?

Lee B. McChesney - *MSA Safety Incorporated - Senior VP & CFO*

Yes, sure. So I think the price impact will be at its most in the first quarter, Rob. And as we go through the year, that will become a smaller part of the consideration, and frankly, that's part of the math and the outlook as well.

We're watching the commodity space closely, just like we're watching the pricing environment as well. And our goal is to keep those in balance. So far, we've done a good job with that. Again, some of the things, we're not going to assume perfection. We'll see how that plays out. It's played out well so far. And I think I'm happy with where we are from a tools and insight perspective, and we'll manage accordingly.

Robert W. Mason - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Would you assume for the full year, a similar, call it, 50-50 weighting between price volume as you had in the first quarter?

Lee B. McChesney - *MSA Safety Incorporated - Senior VP & CFO*

Yes. I think that's the right balance. And I think when you think about the back half, Rob, there could be some opportunities on both sides just depending on how it plays out. But we're just, again, we're going to just continue to be cautious in that back half because of the macro factors.

Robert W. Mason - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Sure. Sure. And then just I'm curious around the book-to-bill that was 1.1 or so. What were the bigger drivers of that being well above or solidly above 1 in the quarter from a product standpoint?

Lee B. McChesney - *MSA Safety Incorporated - Senior VP & CFO*

Well, I'll tell you, it's interesting. I'll let Steve or Nish add in here as well. When you think about the growth we had in the first quarter and then you think about the book-to-bill being positive, that just frankly speaks to a very broad demand environment.

It's funny; if you look at the insights on growth and then when you look at the order number, they're very consistent in terms of being all double digits across the categories in very similar numbers. The only difference is a little bit in the Industrial PP&E space, but that's just partly because the business turns quickly.

Nishan J. Vartanian - *MSA Safety Incorporated - Chairman, President & CEO*

And where we saw, Rob, some real good strength was in the Breathing Apparatus segment, Protective Apparel those were a couple of the real strong ones, and Fire Helmets were also good.

Robert W. Mason - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Nish, I think there was a mention maybe that Fire Service was a little bit softer overseas, but you also called out some wins there. Is that just a timing difference in the quarter? Or how are you -- how does that shape up for the year, I guess?

Nishan J. Vartanian - *MSA Safety Incorporated - Chairman, President & CEO*

Yes, that's correct. It's just seasonality and timing on a quarterly basis. We have some nice orders in the pipeline from an International standpoint. We're really optimistic about that business. We had a nice win, another nice win in the U.K. There are a few more in the pipeline. So we're optimistic about that business. That should be solid throughout the year.

Robert W. Mason - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

I'll get back in the queue.

Operator

And ladies and gentlemen, this concludes our question-and-answer session. I would like to turn the conference back over to Chris Hepler for any closing remarks.

Chris Hepler - *MSA Safety Incorporated - Executive Director of Corporate Development & Investor Relations*

Thank you, Chad, and thank you all for joining. If you miss the portion of today's call, an audio replay will be made available later today on our Investor Relations website and will be available for the next 90 days. We appreciate you joining us this morning, and we look forward to speaking with you again soon. Thank you.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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